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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 774

THE PITTSBURGH & WEST VIRGINIA RAILWAY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 5-9) are reported at 9 T. C. 268. The opinion of the Court of Appeals (R. 11-21) has not yet been reported.

JURISDICTION

The judgment of the Court of Appeals was entered on February 9, 1949. (R. 22.) The petition

for a writ of certiorari was filed on May 9, 1949. The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTION PRESENTED

During the taxable years 1941 and 1942, the taxpayer purchased its own first mortgage bonds at a cost less than the face value of the obligations. Upon acquiring the bonds, the taxpayer pledged them as security for a subsequent and different note issue.

Was the Court of Appeals correct in holding that the taxpayer realized taxable income in 1941 and 1942 when it increased its net assets by purchasing the first mortgage bonds at a cost less than their face value?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 10-11.

STATEMENT

The facts in this case were stipulated (R. 3-5), and were found by the Tax Court as stipulated (R. 6). The taxpayer corporation was organized under the laws of Pennsylvania and West Virginia, and had its principal office in Pittsburgh, Pennsylvania. (R. 6.) It had outstanding certain first mortgage, 4½ percent bonds, series A, B, and C, which were secured by an indenture and supplemental indentures of mortgage dated December 1, 1928, April 1, 1929, April 30, 1929, and April 1,

1930, covering all property (with certain exceptions) then owned or subsequently acquired by the taxpayer. (R. 7-8.)

Later, on July 1, 1940, the taxpayer borrowed $7,400,000 and issued 5-year 4 percent notes secured by an indenture which, among other things, required the taxpayer in each year to utilize a certain percentage of its "Available Net Income" to purchase its outstanding mortgage bonds and to deliver them to the trustee named in the note indenture to be held with other pledged securities subject to the terms of the indenture. If there was a default under the note issue, the trustee was authorized to sell any of the pledged securities, including the mortgage bonds, at public sale. (R. 6-7.) During the time that the mortgage bonds were held in pledge, the taxpayer had no obligation to pay any interest on the bonds to the trustee. (R. 21.)

In the taxable year 1941, the taxpayer purchased $550,000, face value, of the first mortgage bonds for the sum of $349,220, and in the taxable year 1942 it purchased $282,000, face value, of such bonds for the sum of $159,271.25. After the bonds were purchased, they were pledged in accordance with the note indenture, and remained in pledge until June 28, 1945, when they were returned to the taxpayer upon the payment of its notes. (R. 7.)

The Commissioner included in the taxpayer's gross income for the years 1941 and 1942 the difference between the face value of the bonds and the

purchase price paid by the taxpayer. (R. 8.) The Tax Court refused to uphold the Commissioner's determination. (R. 8-9.) On the Commissioner's petition for review, the Court of Appeals reversed, holding that the Commissioner's determination should have been sustained. (R. 11-21.)

ARGUMENT

1. The decision below is correct. When the taxpayer corporation, during the taxable years 1941 and 1942, purchased its own first mortgage bonds at less than face value, it thereby became enriched to the extent that the face amount of the obligations so acquired exceeded the purchase price, and it thereby realized income taxable under Section 22 (a) of the Internal Revenue Code (Appendix, *infra*).* *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *American Chicle Co.*, 291 U. S. 426; *Commissioner* v. *Jacobson*, 336 U. S. 28; Section 19.22 (a)-18, Treasury Regulations 103 (Appendix, *infra*). While the bonds were not retired or cancelled by the taxpayer when they were acquired, there was an immediate decrease in the amount of its outstanding indebtedness which, being greater than the value of the assets used to achieve the reduction, resulted in an increment in net worth and the realization of taxable gain. The failure to retire or cancel the obligations did not prevent the gain from being realized in the taxable years when the bonds were acquired by the tax-

* So far as the record discloses, the bonds were originally issued at face value.

payer. This was the holding of the *Jacobson* case, *supra* (p. 38), where the reacquired bonds were held "intact" by the taxpayer and, ever since Article 22 (a)-18 (1) (c), Treasury Regulations 86, promulgated under the Revenue Act of 1934, the applicable Treasury Regulations have consistently omitted the requirement of previous Regulations that a taxpayer corporation retire its own obligations, and necessitate that the gain be taxed in the year when the obligations are reacquired. In view of the *Jacobson* decision, it is plain that the Regulations express the correct interpretation of the broad scope of Section 22 (a) of the Internal Revenue Code. See *Central Paper Co.* v. *Commissioner,* 158 F. 2d 131 (C. A. 6th); *Tennessee Consol. Coal Co.* v. *Commissioner,* 145 F. 2d 631, 633-634 (C. A. 6th); *Montana, Wyoming & Southern R. Co.* v. *Commissioner,* 77 F. 2d 1007 (C. A. 3d), certiorari denied, 296 U. S. 604; *Garland Coal & Mining Co.* v. *Helvering,* 75 F. 2d 663 (C. A. D. C.).

The taxpayer attempts to escape this result by contending that there was no realization of gain during the taxable years because the bonds, immediately following their acquisition, were pledged as additional security for certain notes, in accordance with the terms of the indenture securing those notes. (Pet. 5-9.) These notes, it should be noted, represented a subsequent indebtedness of the taxpayer quite independent of and not related to its obligation on the mortgage bonds which were purchased during the taxable years. The taxpayer

argues, apparently, that gain on the reacquired mortgage bonds could not be realized while they remained pledged to secure the note issue.

Since the agreement to pledge the bonds was undertaken in connection with an altogether different transaction, the court below was entirely correct in rejecting the taxpayer's attempt to amalgamate these two unrelated matters, and in holding that the determination of gain would not have to (R. 16) "await the outcome of the pledging transaction with the note indenture trustee * * *." When the taxpayer repurchased its bonds from the bondholders at a discount, it was no longer indebted to them, there was a decrease in its total liabilities and, to the extent of the discount, there was a corresponding increase in the taxpayer's net assets immediately upon the acquisition and there was a realization of taxable gain at that time. The resulting income, under well settled principles of annual accounting, was required to be taxed in the years when the taxpayer received the gain. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. The pledging of the bonds to secure the note issue did not have the effect of increasing anew the taxpayer's outstanding indebtedness for it is undeniable, as the court below observed (R. 18), that the total obligation to the noteholders remained the same after the pledge as it had been before. The taxpayer acquired the mortgage bonds as an owner; it pledged them as an owner; it continued to remain the owner

while they were pledged; it had no obligation, not even that of paying interest, so long as the pledge continued. Cf. *Commissioner* v. *Jacobson,* 336 U. S. 28, 38. The fact that the taxpayer, by reason of the pledge, had voluntarily deprived itself of the authority to cancel or retire the bonds immediately (Pet. 9-10), does not affect the matter since they did not represent an outstanding obligation while they were held in pledge. There is, accordingly, no reason why the gain enjoyed by the taxpayer at the time when it increased its net assets should be postponed from taxation until the bonds were released from pledge.

It is true that if the taxpayer should have subsequently defaulted on the notes the trustee would have been empowered to resort to the security afforded under the note indenture, including the authority to sell the mortgage bonds; this would have had the effect of renewing the taxpayer's obligation on the bonds. However, even though it were possible that the taxpayer's total indebtedness might be increased in the future because of a separate and distinct transaction, and that the gains achieved by the taxpayer during the taxable years when it repurchased the mortgage bonds might be diminished or erased in a subsequent tax year as a consequence of this unrelated transaction, it would not follow that the gains should go untaxed in the years when they in fact occurred. Cf. *Burnet* v. *Sanford & Brooks Co., supra,* pp. 364-366; *Helvering* v. *Bruun,* 309 U. S. 461, 467; *Helvering*

v. *American Chicle Co.,* 291 U. S. 426, 430; *North American Oil* v. *Burnet,* 286 U. S. 417, 424.

2. There is no conflict of decisions. *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, rests on the principle that taxable gain is realized when the debtor's net assets are increased because of a reduction of outstanding obligations accomplished by a lesser expenditure. Since such an increase took place in the taxable years here involved, the holding below follows the *Kirby Lumber Co.* decision and does not (Pet. 5-6) conflict with the rule of that case. The other decisions relied on by the taxpayer (Pet. 10-11), *Walker* v. *Commissioner,* 88 F. 2d 170 (C. A. 5th), certiorari denied, 302 U. S. 692, and *Commissioner* v. *Cleveland Trinidad Pav. Co.,* 62 F. 2d 85 (C. A. 6th), are similarly not opposed to the decision of the court below. In the *Walker* case it was held that the gain was taxable in the year when the taxpayer's net assets were increased by a reduction of indebtedness, and not in an earlier year when the parties had agreed to settle the indebtedness in the future. The decision in the *Walker* case is thus in harmony with the decision here where the gain is also being taxed in the years when the taxpayer's outstanding liabilities were decreased and its net assets increased. The *Cleveland Trinidad Pav. Co.* case, holding that a cash basis taxpayer is not in receipt of income until the year in which it is entitled to receive the income, plainly has no bearing on the issues here presented.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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JUNE 1949.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
(26 U. S. C. 22.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.22(a)–14. *Cancellation of indebtedness.*—(*a*) *In General.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See section 19.22(a)–18.) * * *

Sec. 19.22(a)–18. *Sale and purchase by corporation of its bonds.*—(1) (*a*) If bonds are

issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

* * * *

Sections 29.22(a)–13 and 29.22(a)–17, Treasury Regulations 111, promulgated under the Internal Revenue Code and applicable to the taxable year 1942, contain provisions which are identical with those of Section 19.22(a)–14 and 19.22(a)–18 of Treasury Regulations 103 set forth above.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1949 839003 648